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In the Supreme Court of the United States

OCTOBER TERM, 1929

THE ALUMINUM CASTINGS COMPANY, PETITIONER

v.

CARL F. ROUTZAHN, INDIVIDUALLY AND AS COLLECTOR OF INTERNAL REVENUE

ON WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE SIXTH CIRCUIT

BRIEF FOR RESPONDENT

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No. 198

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BRIEF FOR RESPONDENT

OPINIONS BELOW

The opinion of the United States District Court for the Northern District of Ohio (R. 9–15) is reported in 24 F. (2d) 230. The opinion of the United States Circuit Court of Appeals (R. 151–155) is reported in 31 F. (2d) 669.

JURISDICTION

The judgment of the United States Circuit Court of Appeals (R. 151) was entered on April

2, 1929 (R. 151). Petition for certiorari to review the judgment was filed June 26, 1929, and was granted by this Court on October 21, 1929. (R. 155–156.) The jurisdiction of this Court rests on Section 240 (a) of the Judicial Code as amended by the Act of February 13, 1925.

QUESTION PRESENTED

Was the Commissioner correct in refusing to allow the munition manufacturer's tax of the petitioner for the year 1916 as a deduction from gross income for the year 1917, when the tax was paid? This depends upon whether or not petitioner kept its books and made its return on the accrual basis.

STATUTE INVOLVED

The pertinent portions of the Revenue Act of 1916, c. 463, 39 Stat. 756, 767, 770, 771, read:

> SEC. 12. (a) In the case of a corporation, joint-stock company or association, or insurance company, organized in the United States, such net income shall be ascertained by deducting from the gross amount of its income received within the year from all sources—
>
> First. All the ordinary and necessary expenses paid within the year in the maintenance and operation of its business and properties * * *.
>
> * * * * *

SEC. 13. (a) The tax shall be computed upon the net income, as thus ascertained, received within each preceding calendar year ending December thirty-first:

* * * * *

(d) A corporation, joint-stock company or association, or insurance company, keeping accounts upon any basis other than that of actual receipts and disbursements, unless such other basis does not clearly reflect its income, may, subject to regulations made by the Commissioner of Internal Revenue, with the approval of the Secretary of the Treasury, make its return upon the basis upon which its accounts are kept, in which case the tax shall be computed upon its income as so returned;

* * * * *

STATEMENT

During 1916 and 1917 petitioner manufactured aluminum, brass and bronze castings, including munitions of war. The profits from the sale of such articles were subject to the munitions tax under Title III of the Revenue Act of 1916, c. 463, 39 Stat. 756, 780. During the year 1916 petitioner realized substantial profits upon the sales of such articles and the munitions tax for 1916 amounted to the sum of $246,275.63, which tax was paid by the petitioner in 1917.

Petitioner deducted the amount so paid from gross income for the year 1917 in determining the

amount of net income subject to income and excess profits taxes. (R. 24.) Petitioner stated on the tax return filed for 1917 that it was filed upon the cash receipts and disbursements basis, except that "bills and accounts payable and receivable are treated as receipts and disbursements." (R. 31, 34; Pet. Exhibit 3, R. 98.) The 1916 return was filed on the same basis, that is, " bills and accounts payable and receivable being entered as cash" (R. 35), although it was stated in the return filed for that year that the cash basis was used. (Pet. Exhibit 1, R. 81.) Upon a reaudit of the returns filed for the years 1916 and 1917, the Commissioner of Internal Revenue disallowed the deduction of the munitions tax in the sum of $246,275.63 from the gross income of petitioner for the year 1917, transferred it to the year 1916, and allowed it as a deduction from gross income for that year. (R. 24, 29.) This adjustment resulted in an additional tax for the year 1917 in the net sum of $148,364.45 (R. 25, 30), which sum, together with interest, is the amount sought to be recovered in this suit.

The District Court held that petitioner's books of account for the years 1916 and 1917 were kept on an accrual basis and its income returns for those years were made on the accrual basis, and that its munitions tax on profits earned in 1916 was deductible from its income for that year and not from its income for 1917. (R. 11.) Judgment was accordingly entered for respondent. (R. 26.)

The Circuit Court of Appeals for the Sixth Circuit affirmed the judgment of the District Court. (R. 151.)

SUMMARY OF ARGUMENT

Under the rule announced by this Court in *United States* v. *Anderson,* 269 U. S. 422, munitions taxes payable under Title III of the Revenue Act of 1916, on account of profits realized during 1916, accrued in that year. If the income tax return for that year is filed on an accrual basis, the sum payable as munitions taxes is deductible from gross income for 1916 and not 1917, for the purpose of computing the net income subject to income taxes. The petitioner's books of account were kept, and its tax returns were filed, on the accrual basis.

Notwithstanding the option given taxpayers to report on the accrual basis, the underlying purpose of the Act is to require returns that clearly reflect taxable income. In order to effectuate such a purpose it is necessary that the Commissioner have power to make corrections in all returns, irrespective of the basis upon which they are made. Such authority has been assumed without discussion by this Court, the Court of Claims, and others.

ARGUMENT

I

This Court decided in *United States* v. *Anderson,* 269 U. S. 422, that munitions taxes, assessable and payable under Title III of the Revenue Act of 1916

on account of net profits realized from the sale of munitions of war during the year 1916, accrued in that year, and that if the taxpayer's books were kept and its tax return for 1916 was filed on an accrual basis the munitions taxes were deductible from gross income for 1916, when accrued, and not in 1917, when due and payable. The rule announced in that case limits the scope of the controversy herein to the questions whether or not petitioner's books of account were in fact kept on the accrual basis, and whether its returns were actually filed on the accrual basis. If they were, we submit that this Court's decision in the *Anderson case* is controlling.

A trial by jury having been waived in writing (R. 7), the District Court made special findings of fact and conclusions of law. The findings of fact specifically state that petitioner, during the years 1916 and 1917, "kept its accounts upon a basis other than that of actual receipts and disbursements, commonly known as an accrual basis," and also that petitioner's tax returns for those years "were made, returned and filed on the basis on which its accounts were kept as aforesaid, viz., an accrual basis." (R. 25–26.) The Circuit Court of Appeals so held. (R. 155.)

These conclusions are supported by the evidence.

Testimony of petitioner's witness Watson, who made out petitioner's tax returns (R. 31), shows that for the years 1916 and 1917 petitioner had

accrued on its books bills receivable, accounts receivable, bills payable, accounts payable (R. 31, 35, 36), accrued taxes (R. 32, 36) other than accrued munitions taxes (R. 32), items of sales invoiced to purchasers before the money was received (R. 34), reserves for losses on doubtful accounts (R. 36), unpaid labor comprising both unpaid and unclaimed wages (R. 36), and reserves set up to take care of future possible expenditures and present unliquidated liabilities, such as reserves for commissions, for liability insurance, for fire insurance, for legal expenses, for high-priced metal, for Federal income taxes, for open receiving slips, and for unadjusted claims. (R. 36.)

Petitioner's witness Basler, an accountant who was in complete charge of its books of account during the years 1916 and 1917, and who assisted in the preparation of its tax returns for those years, testified that there were accrued on petitioner's books accounts payable, accounts receivable (R. 39–40), reserves for depreciation (R. 41), and prepaid expenses (R. 41).

Respondent's witness Dewey, a certified public accountant, who, while an Internal Revenue Agent, examined petitioner's books of account for the years in question, testified that petitioner's books were kept on the accrual basis because it used accounts receivable and payable and accrued various items on its books as representing a liability that had not yet been paid in cash but were to be paid in the future, having been incurred but not paid; that

he applied that rule to the bills and accounts payable as well as to items of insurance and taxes; that on the cash basis accounts receivable and payable are not taken into consideration but only the money actually received, that is, if a sale is made but the money is not then received, no entries are made on the books until the money is received (R. 42); and that his examination convinced him that the books were kept on the accrual basis (R. 45).

Respondent's witness Cohen, a certified public accountant and Internal Revenue Agent, testified that he examined petitioner's books for the years 1916 and 1917 for the purpose of determining on which basis of accounting they were kept; that his "conclusion was that they were kept on the accrual basis"; that he "examined the income tax returns and excess-profits tax returns for the years 1916 and 1917, filed by this Company" and "they appeared to be filed on the accrual basis"; that his conclusion was based on the facts that petitioner accrued on its books items of expense, and carried deferred charges as assets; that its tax returns appeared to be filed on the accrual basis because it took into consideration accounts receivable and accounts payable as cash items; that petitioner's balance sheets contained items indicative of the accrual system of keeping books, such as prepaid expenses, accounts receivable, reserves for doubtful accounts, notes receivable, accounts payable, unpaid labor, and reserves for accrued liabilities such as reserves for commissions, accrued taxes and legal expenses. (R. 46–47.)

Petitioner contends that its return of income for 1916 was not made on the accrual basis but on the "statutory" cash receipts and disbursements basis, as prescribed by previous regulations.

It is true that on September 14, 1916, the Commissioner of Internal Revenue instructed the collectors as follows (R. 134):

> Pending the adoption and promulgation of special regulations under the Act of September 8, 1916, Income Tax Regulations in Force September 8, 1916, are hereby extended and made applicable to the Act of September 8, 1916, so far as not inconsistent with the provisions of that statute.

On the strength of this ruling petitioner contends that it was permitted to file its return for 1916 on the same type and character of cash receipts and disbursements basis which had been required under the 1913 Act. The flaw in the argument of the petitioner is in assuming that such a return therefore constituted a return upon the basis of actual receipts and disbursements. This is demonstrated by the opinion of this Court in *United States* v. *Anderson, supra,* in which this Court said (269 U. S., at 440):

> A consideration of the difficulties involved in the preparation of an income account on a strict basis of receipts and disbursements for a business of any complexity, which had been experienced in the application of the Acts of 1909 and 1913 and which made it

necessary to authorize, by departmental regulation, a method of preparing returns not in terms provided for by those statutes, indicates with no uncertainty the purpose of Sections 12 (a) and 13 (d) of the Act of 1916. It was to enable taxpayers to keep their books and make their returns according to scientific accounting principles, by charging against income earned during the taxable period, the expenses incurred in and properly attributable to the process of earning income during that period; and indeed, to require the tax return to be made on that basis, if the taxpayer failed or was unable to make the return on a strict receipts and disbursements basis.

The appellee's true income for the year 1916 could not have been determined without deducting from its gross income for the year the total cost and expenses attributable to the production of that income during the year. The reserve for munitions taxes set up on its books for 1916 must have been deducted from receivables for munitions sold in that year before the net results of the operations for the year could be ascertained. The taxpayer being unable to make its return on a strict receipts and disbursements basis, and not having attempted to do so, could not have complied with Section 13 (d) and Treasury Decision 2433 by deducting either accruals of interest or expenses alone without the other, or without deducting other reserves made on its books to meet liabilities

> such as the munitions tax, incurred in the process of creating income.

The petitioner contends that it designated its return as made upon the cash receipts and disbursements basis. That fact, of course, is not controlling. The return was not made upon a strict receipts and disbursements basis. Whether the taxpayer could have made a return on such a basis we need not consider. The District Court said that it is probable that it could not have made a return on that basis, by which we assume that it meant that it could not have made a return on that basis which would have reflected its true income on account of the nature of its business, its manner of keeping its accounts, and the basis upon which its previous returns had been prepared. It is quite possible that it would not have been permitted by the Commissioner to compute its income on a strict receipts and disbursements basis, but that question is not involved in the instant case. The legislative history of the Act indicates that Section 13 (d) referred to only two kinds of returns, based upon the two fundamental systems of accounting, and permitted the selection only of that basis which would clearly reflect income. The report of the Ways and Means Committee of the House (H. Rept. No. 922, 64th Congress, First Session, p. 4), respecting the enactment of Section 13 (d) said:

> As two systems of bookkeeping are in use in the United States, one based on the cash or receipt basis and the other on the accrual basis, it was deemed advisable to provide in

> the proposed measure that an individual or corporation may make return of income on either the cash or accrual basis, if the basis selected clearly reflects the income.

In view of the fact that petitioner failed to make its return on the "strict receipts and disbursements basis," we submit that it was *required* to file its return on the accrual basis.

The District Court disposed of petitioner's contentions in the following language (R. 14–15):

> Plaintiff's income return conforms to its books as thus kept, with certain limited exceptions. It did not deduct in its return the full reserve of $108,006.55 set up for federal income tax, but only the amount of taxes actually paid during the year 1916. It did not deduct all of the other amounts set up as reserves. It may even be conceded that the other reserves were disregarded, except so far as actually used or necessary to discharge liabilities actually paid during 1916, or the amount of which was definitely ascertained. The fact remains, however, that plaintiff's books were kept and plaintiff's return was made substantially upon an accrual basis. It is probable that plaintiff could not have made an income return on a strict basis of actual receipts and disbursements. Section 13 (d), as was said in the Anderson case, was enacted to meet this situation. Its effect is to compel a departure from the practice followed prior to 1916, whenever the taxpayer keeps his books or attempts to make his return otherwise than on a strict basis of re-

ceipts and disbursements, or when he is not able to make it in that way. An election results from what is done, notwithstanding the taxpayer may disclaim any such intention.

As I understand the facts of the Anderson case, they were not substantially different from the facts of this case. The difference most strongly stressed is that in the Anderson case, a reserve, beginning with September, 1916, was in fact set up to take care of the munitions tax, whereas in this case none was set up, owing probably to the plaintiff's belief that its product was not subject to the munitions tax. But in the Anderson case that reserve was closed out by entry made December 31, 1916. A distinction can not be based upon an entry thus made and later corrected, and a mere failure to make any entry at all. The controlling facts of the two cases are the same.

The Circuit Court of Appeals in the instant case said (R. 154–155):

> It is objected that prior to 1916 no other basis for return was recognized than that upon cash receipt and disbursement basis; that the internal revenue regulations then definitely recognized and established that differences in inventory value, accounts receivable and payable created during the year, and depreciation, were proper items for inclusion in a return upon the cash receipt and disbursement basis and were recognized as cash items; that section 13 (d) did not vary this prior practice but, the regulations

and requirements of the Department remaining unchanged, simply gave to the taxpayer the option of making its return upon an accrual basis; that these items thus continued and remained proper "cash items" in a receipt and disbursement return unless the taxpayer had elected to make return upon some other basis; and that this plaintiff has definitely refused to so exercise such option. These contentions are likewise answered by the case of *United States* v. *Anderson, supra,* at pp. 439, 440. The difficulty if not the utter impossibility of preparing a return upon a strict basis of receipts and disbursements in most cases constituted at once the reason and necessity for the enactment of section 13 (d). The mere fact that by the prior law a return upon the basis of receipts and disbursements was alone recognized and required and the fact that, for reasons of necessity and expediency and in order that the return might truly reflect the income of the taxpayer, the department was driven to permit and require the use of accrual items in then making such returns, do not irrevocably classify such items as actual receipts and disbursements or preclude return to and application of correct definition when the machinery therefor is provided.

II

The Commissioner had full authority to correct tax returns filed on the accrual basis.

The question whether or not the correction by the Commissioner of income and profits tax returns filed on the accrual basis for the years 1916 and 1917 *ipso facto* requires the computation to be made on the cash receipts and disbursements basis was raised in the petition for certiorari. Since the same question is also involved in the cases of *United States* v. *American Can Company, et al.*, Nos. 128, 129 and 130, October Term, 1929, now pending before this Court on writs of certiorari, and is fully argued in the brief for the United States in those cases, it seems unnecessary to repeat the argument here. Copy of the brief in the *American Can Company cases* has been served on counsel for petitioner in the instant case.

In those cases the correction made by the Commissioner concerned the method adopted in keeping inventories. The correction made here involved a single item of tax liability which had not been taken into account by a taxpayer on the accrual basis. We submit that the theory that a correction by the Commissioner in a return on the accrual basis necessitates a return on the cash basis is unsound and needs no further argument here.

CONCLUSION

In view of the foregoing, it is respectfully submitted that the judgment of the court below is correct and should be affirmed.

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ON WRIT OF CERTIORARI TO THE CIRCUIT COURT OF APPEALS FOR THE SIXTH CIRCUIT

BRIEF FOR THE RESPONDENT ON REARGUMENT

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